Chevron

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ESTABLISHING OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES; FURTHER SUPPLEMENTARY PROPOSED RULE; 63 FR 38355 (JULY 16, 1998)

Dear Sir:

Chevron U.S.A. Production Company, a Division of Chevron U.S.A. Inc. ("Chevron"), appreciates the opportunity to comment on the subject further supplementary proposed rule which contains changes to the February 6, 1998 second supplementary proposed rule appearing at 63 FR 6113 ("February 6 proposal"). As one of the largest lessee/payors of royalties on oil produced from federal leases, Chevron is significantly affected by the July 16, 1998 further supplementary proposed rule ("July 16 proposal") and the February 6, 1998 second supplementary proposed rule. Chevron endorses and adopts by reference herein the comments on the February 6 proposal and the July 16 proposal submitted by The Barents Group, LLP, and the industry executives who have met with MMS recently at the request of various members of Congress. Chevron also incorporates by reference, and reiterates herein, all its prior comments submitted either in its own name or by means of incorporation by reference in this crude oil valuation rulemaking.

<u>I. Preferred Alternative to the February 6 and July 16 Proposals</u>.

Again, Chevron encourages MMS to do the right thing for the American people by taking federal royalty in kind. In so doing, production value could be established at the time of production by means of an agreed upon sale price, rather than during audit many years later, as in the case of royalty paid in value. Payment of royalty in value to the government has become the equivalent of writing America a <u>blank</u> check, with the amount not determined until years later, after costly and time consuming audits, administrative appeals, and litigation. This is because the Department's interpretation of its valuation regulations and its verification of royalty payments invariably do not occur until many years after the royalties have been paid. Lessees, on the other hand, must interpret the valuation rules and calculate and pay royalty by the end of the month following production. It is no wonder that disputes arise. By way of example, what lessee could have foreseen when making royalty payments on natural gas liquids ("NGL") how the Department would eventually interpret its NGL valuation regulations in the infamous "Procedure Paper"? And who could have known when the 1988 valuation rules were adopted that the Department would, many years later, adopt the position that ANS spot prices should have been used to calculate royalty value on oil produced from federal leases in California rather than posted prices? As will be demonstrated herein, MMS' February 6 proposal, as amended in the July 16 proposal, attempts to fix the inherent problems that have arisen from requiring royalty payments in value with more complicated and ambiguous valuation rules, but this fails to break the recurring cycle of uncertainty.

A comprehensive royalty-in-kind program would allow the government to eliminate cadres of federal employees now required to verify and ascertain royalty value. It would allow the government to participate in downstream markets, with the expectation of achieving higher revenues, without imposing on federal lessees an obligation to market royalty production differently from the working interest share. Finally, a comprehensive royalty-in-kind program would achieve what all Americans, from federal lessees to schoolchildren supported by federal royalty dollars, have the right to know, namely, the correct value of production from federal lands at the time of severance.

II. General Comments on the July 16 Proposal.

We initially comment that the short 14-day time period allowed by MMS for comments on the July 16 proposal is inadequate to fully comment on the proposal. MMS' action has placed federal lessees at an extreme disadvantage and would appear intended to limit stakeholder comments rather than encourage them.

We are also want to emphasize that MMS should weigh the comments it receives in consideration of the relative interests of the parties affected by the proposal. MMS asks whether movement of production from sub-sea production over long distances, e.g., 50 miles, should be deductible as a transportation allowance. 63 FR 38356 As described by MMS, such movement could only originate from offshore federal leases located so far offshore as to be exclusively federal and not covered by the *Minerals Lands Leasing Act* or Section 8(g) of the *Outer Continental Shelf Lands Act*. If history is repeated in the comments MMS receives, we expect the States and Indian tribes will comment against permitting such allowances. States and Indian tribes could neither share in royalty revenues from, nor audit under a cooperative agreement, any such leases. Therefore, states and Indian tribes would not appear to be affected by or have the same level of interest in this proposal as federal lessees in the Outer Continental Shelf. We believe MMS should give considerable weight to comments supplied by its OCS lessees.

We do not believe that MMS has adequately addressed the difficulty of theoretical tracing of proceeds from downstream transactions back to individual federal leases, as required by

§206.102(a). Sales at downstream locations can be quite numerous rarely specify a source of the oil sold. Consequently, the proposed rule would require Lessees to weight-average hundreds of prices, gravities, and transportation costs (many based on "actual costs", that is, not based on published FERC tariffs) in order to pay royalty in accordance with §206.102(a). We therefore recommend that §206.102(a) be amended as follows:

> (a) The value of oil under paragraphs (a)(1) through (4) of this section is, at the lessee's option, the methodology set forth in §206.103 or the gross proceeds accruing to the seller under the arm's-length contract . . .

The option is necessary because some lessees will simply not be able to trace proceeds in any rational manner while others are willing and able to do so. However, whatever method is used, we remain concerned about the lack of adequate adjustments in the February 6 proposal, and we encourage MMS to study this matter further.

The most troubling aspect of the July 16 proposal, and the February 6 proposal, is that the proposed oil valuation rule remains full of "Valuation Crisis Points" -- language which so vague, ambiguous and subject to conflicting interpretation that lessees are effectively precluded from any reasonable assurance of accuracy when making a royalty payment. Because of these Valuation Crisis Points (all of which we may be unable to completely identify in the short comment period allowed), valuation disputes would increase if the rule were finalized in its present form. The continued existence of so many Valuation Crisis Points in the February 6 and July 16 proposals can only arise from a fundamental misunderstanding of the crude oil business by MMS. <u>No final crude oil valuation rule should be published until these fundamental misunderstandings and Valuation Crisis Points are eliminated.</u>

III. Specific Comments on the July 16 Proposal

Gathering vs. Transportation

MMS specifically requests comments on whether the cost of moving bulk production over great distances from a sub-sea completion to a platform where it first surfaces and is treated should be deductible as a transportation allowance. 63 FR 38356. We strongly believe that MMS should grant a transportation allowance for the movement of <u>any</u> bulk production to a measurement or treatment point off the lease, provided the allowance covers only the cost of moving the royalty bearing substances contained in the bulk stream.

MMS has historically considered all movement upstream of the point of measurement and placing production in marketable condition to be gathering. The distinction between non-deductible gathering costs and deductible transportation costs resulted from MMS' unwillingness to share in the cost of moving non-royalty-bearing substances. However, technological advances have obtained production in places where it is impractical to install treatment and measurement facilities. Lessees, acting as prudent operators, must install them in the most cost-effective and practical location possible. Retaining the existing distinction between gathering and transportation will unfairly limit transportation allowances in more and more instances. MMS may just as easily avoid sharing in the cost of moving the non-royalty bearing substances by limiting bulk transportation allowances to the cost allocable to moving the royalty bearing components only. At the same time, having to bear the full cost of moving the non-royalty bearing portion of the bulk stream would also encourage lessees to locate treatment and measurement facilities as close to the lease as possible.

§ 206.101 Definition of Affiliate

In attempting to address industry concerns that lessees would be excluded from using their gross proceeds as value in bona fide arm's-length transactions, MMS proposes to retain the current meaning of affiliate embodied in the current rules. Retaining the current meaning of affiliate does not adequately address industry concerns. The lack of specifics on how the presumption of control may be successfully rebutted by a lessee and the effects of having made such a showing render the proposed definition of affiliate a Valuation Crisis Point.

The preamble states: "ownership of between 10 and 50 percent would create a presumption of control <u>that the lessee could rebut</u>," 63 FR 38356 (emphasis supplied). However, the proposed definition of affiliate states: "ownership of 10 through 50 percent creates a presumption of control." 63 FR 38357. The definition (not just the preamble) should state that the presumption of control may be rebutted by the lessee. It should also set forth guidelines on what showing must be made in order to successfully rebut the presumption. We suggest the following: (1) that the lessee and the related entity not have the same officers, directors, and employees; (2) that the lessee not have the ability to control the day-to-day business activities and decisions of the related entity; and that the lessee and the related entity not file consolidated income tax returns. Finally, the definition should clearly state that the result of successfully rebutting the presumption of control is that transactions between the lessee and the affiliate will be considered arm's-length.

§ 206.102(c)(2)(ii) Disallowance of Arm's-length Gross Proceeds Due to Breach of Lessees' Duty to Market

In response to concerns that MMS would use this provision to "second guess" lessees' marketing decisions and force them to use index-based valuation, MMS proposes adding the following language: "MMS will not use this provision to dispute lessees' marketing decisions made reasonably and in good faith. It will apply only when a lessee or its affiliate inappropriately sells its oil at a price substantially below market value."

While MMS' intentions are commendable, the proposed language is too vague and fails to adequately address industry concerns. The lack of specificity regarding how MMS will determine a marketing decision has not been made in good faith, and how it will determine that an inappropriate sale at a price substantially below market value has occurred, render this provision a Valuation Crisis Point. What is an "inappropriate sale?" How much is "substantially below market value?" As written, the provision could still lead to widespread "second guessing," especially in light of the high lease netback values that will result from limiting deductions from downstream sales. For example, assume Lessee A sold its oil at the lease for $14/Bbl and other lessees sold their oil at a downstream market center for $17/Bbl less $.75 transportation? Couldn't MMS use this provision to assert that $14/Bbl was substantially below the "market value" of $16.25? How could Lessee A even be aware of its competitors' sale prices or be able to protect itself from such valuation uncertainty? What showing should be made regarding the lessee's or affiliate's knowledge or intent?

Without clear guidelines, interpretations by lessees and MMS auditors will vary and it may be many years before the Department interprets these provisions. Lessees will remain exposed to enormous valuation risk and uncertainty. We suggest that such uncertainty would be avoided if the language were changed to: "MMS will not use this provision in the absence of a finding by the Associate Director for Royalty Management that a lessee or affiliate sold its production at a price it considered to be substantially below market value, provided, further, that such a finding will not be made by the Associate Director until the lessee has been afforded notice and an opportunity to be heard." This language would better ensure that such a drastic remedy would be applied consistently by MMS, at the highest levels of the agency, and based on a finding of intentional misconduct by a lessee or affiliate.

§ 206.102(c)(3) Exchange Agreements

This provision is characterized by numerous Valuation Crisis Points. In response to industry and State comments claiming that tracing multiple exchanges would be overly burdensome, if not impossible, MMS states in the preamble that it proposes to return to its July 3, 1997 supplementary proposed rule's "first-exchange" rule, which gave the lessee the option to use either its gross proceeds or the index pricing method for oil exchanged and then sold at arm's length. 63 FR 38356. Inexplicably, however, the new § 206.103(c)(3) is only a partial return to the July 3, 1997 provision, because the provision now states that oil exchanged and then sold at arm's length must be valued on the gross proceeds for the oil received in the exchange. Why was the index-based option originally appearing in the July 3, 1997 provision not restored?

MMS fails to understand that the problems associated with tracing multiple exchanges also apply to "first-exchanges." It is not uncommon for a lessee or affiliate to ship production from different fields directly into a market center where dozens of "first-exchanges" into other market centers would take place. For example, assume there are 50 federal leases which flow into Empire from different locations on a pipeline system. Lease A produces 300,000 Bbl/month. The total production flowing into Empire is 2,000,000 Bbl/month. Of the 2,000,000 Bbl flowing into Empire, 50,000 Bbl are sold in 10 arm's length outright sales at Empire, and 450,000 Bbl are traded into St. James in 30 buy/sell agreements, and 1,500,000 Bbl are traded into Cushing via 75 buy/sell agreements. The lessee of Lease A would face numerous Valuation Crisis Points plus a potentially insuperable administrative burden as a result of MMS' present "first-exchange" rule. Since none of the dispositions at Empire refer to Lease A, must the lessee assume that 300,000/2,000,000, or 15%, of every Bbl disposed of at Empire should be allocated back to lease A? If so,

- 15% of the 50,000 Bbl sold at Empire in 10 outright sales, or 7,500 Bbl, should be allocated to Lease A. These 7,500 Bbl would be valued, pursuant to § 206.102(a), based on gross proceeds from the weighted average of the 10 arm's length sales at Empire.

- 15% of the 450,000 Bbl traded into St. James in 30 buy/sells, or 67,500 Bbl, should be allocated to Lease A. However, there is not a "single exchange" between Empire and St. James, but rather 30 separate "single exchanges." The lessee would have to interpret § 206.102(c)(3), and assuming it requires the lessee to trace the 30 buy/sells into St. James, in order to apply the "first-exchange" rule, the lessee must examine each disposition at St. James:

  - Outright sales at St. James would have to be weight averaged and allocated back to Empire, and then to Lease A and all other 50 leases flowing into Empire to be valued under § 206.102(a). In order to determine the location differential to apply to the St. James oil dispositions allocable to Lease A, the location differentials in the 30 buy/sells between Empire and St. James would have to be weight averaged. Any retroactive adjustments to run ticket volumes or pricing would require retroactive adjustments to all allocations from St James back to Empire. Finally, after all this tracing, the lessee would still have to live with the uncertainty that its arm's length sales values received in the outright sales at St. James could be determined to be substantially below market value pursuant to § 206.102(c)(2)(ii) and revalued under § 206.103, or that one or more of its 30 arm's length exchange agreements between Empire and St. James did not reflect reasonable location or quality differentials, thereby requiring revaluation under § 206.103.

  - Buy/sells from St. James to other locations would be considered "multiple exchanges" for Lease A, but not necessarily for other production flowing into St. James. The portion of St. James buy/sells allocated to Lease A would be valued according to § 206.103, by applying the appropriate index applicable to production from Lease A, probably the Empire spot price, adjusted for location differentials. Any retroactive adjustments for leases flowing into Empire, or for volumes in the buy/sells between Empire and St. James could necessitate the reallocation of all volumes between St. James, Empire, and Lease A.

- 15% of the 1,500,000 Bbl traded into Cushing in 75 buy/sells, or 225,000 Bbl, should be allocated to Lease A. However, there is not a "single exchange" between Empire and Cushing, but rather 75 separate "single exchanges." The lessee would have to interpret § 206.102(c)(3), and assuming it requires the lessee to trace the 75 buy/sells into Cushing, in order to apply the "first-exchange" rule, the lessee must examine each disposition at Cushing:

  - Outright sales at Cushing would have to be weight averaged and allocated back to Empire, and then to Lease A and all other 50 leases flowing into Empire to be valued under § 206.102(a). In order to determine the location differential to apply to the Cushing oil dispositions allocable to Lease A, the location differentials in the 75 buy/sells between Empire and Cushing would have to be weight averaged. Any retroactive adjustments to run ticket volumes or pricing would require retroactive adjustments to all allocations from Cushing back to Empire. Finally, after all this tracing, the lessee would still have to live with the uncertainty that its arm's length sales values received in the outright sales at Cushing could be determined to be substantially below market value pursuant to § 206.102(c)(2)(ii) and revalued under § 206.103, or that one or more of its 75 arm's length exchange agreements between Empire and Cushing did not reflect reasonable location or quality differentials, thereby requiring revaluation under § 206.103.

- Buy/sells from Cushing to other locations would be considered "multiple exchanges" for Lease A, but not necessarily for other production flowing into Cushing. The portion of Cushing buy/sells allocated to Lease A would be valued according to § 206.103, by applying the appropriate index applicable to production from Lease A, probably the Empire spot price, adjusted for location differentials. Any retroactive adjustments leases flowing into Empire, or for volumes in the buy sells between Empire and Cushing could require retroactive adjustments to all allocations from Cushing back to Empire and Lease A.

As demonstrated in the example above, limitation of tracing exchanges to "first-exchanges" achieves little and remains so burdensome as to render the proposal unworkable for lessees or affiliates who have "first-exchanges" between market centers. In order to eliminate the necessity to trace gross proceeds through "first exchanges," MMS should either accept the sale side of an arm's-length exchange as an arm's-length dispositions, or restore the lessee's option to choose between tracing gross proceeds or using §206.102(c) to value "first-exchanges."

We also recommend clarifying the provisions of § 206.102(c)(3) in order to eliminate various Valuation Crisis Points. MMS should clarify what it means by "single" exchange. Does it mean "one, and only one, exchange," or does it mean "initial exchange, or exchanges"?

The provision also contains the statement: "But if MMS determines that any arm's-length exchange agreement does not reflect reasonable location or quality differentials, MMS may require you to value the oil under § 206.103." This language is too vague and fails to provide specifics for making such a determination. Lessees will therefore be exposed to too much uncertainty. We suggest adding changing the provision: "But if the Associate Director for Royalty Management determines, after affording you notice and an opportunity to be heard, that any arm's-length exchange agreement does not reflect reasonable location or quality differentials due to your misconduct, MMS may require you to value the oil under § 206.103."

IV. Conclusion

We are extremely concerned that, after numerous comments, MMS appears to be making only limited changes to the February 6 proposal. Such limited changes will not fix the problems inherent in the current proposal. For example, MMS has not adequately addressed concerns that its index methodology does not contain adequate quality and location adjustments to arrive at a lease value and should be replaced by benchmarks previously identified. In addition, MMS has failed to address industry concerns about the Form MMS-4415 and its attendant administrative burdens. MMS has not addressed the failure of its methodology to contain proper adjustments between the aggregation point and the lease. Finally, MMS has failed to address the lack of binding valuation guidance when requested by the lessee.

These core flaws will effectively prevent most lessees from being able to comply with the rule. MMS is encouraged to eliminate these core flaws and the various Valuation Crisis Points, and to take the time necessary to re-examine this proposal.

Respectfully submitted,

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